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Global growth: Green shoots or false dawn?

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- Since the Trump Administration announced in early October its intent to seek a phased trade agreement with China, financial conditions and growth prospects have been lifted. Constructive developments regarding Brexit have added to this positive drift. Our analysis suggests that business sentiment is now forming a bottom on a global scale and is likely to show modest improvement as we move into 2020, with risks of near-term recession declining.
- In the US, our models based on a wide variety of leading indicators tell us that growth is bottoming in the current quarter at a pace well below potential. Recession risks have declined noticeably assuming progress continues on the trade front, and a moderate upturn in growth ahead still seems in train, though election uncertainty should cap the upside.
- In Europe, too, the more cyclical manufacturing sector data have started to improve, helped by export orders, and our euro area data surprise indicator has turned positive for the first time in 20 months. With policy uncertainty diminishing, spillover from weak manufacturing to the rest of the economy should be limited. We continue to expect EA growth to move sideways through the winter and pick up slowly beginning in Q2.
- Asia has been hit hard by the trade conflict, especially the smaller, more open economies. China's domestic demand growth may have bottomed, and we expect enough recovery in its trade and investment to about offset the secular downtrend in GDP growth. In Japan, external orders have begun to rise again, and the economy should begin to recover by Q2 as the effects of the recent consumption tax hike fade.
- Our call that a global bottoming is near rests importantly on the assumptions that a Phase 1 trade deal with China is signed, auto tariffs are put aside, and hard Brexit risks subside. But the global economic picture remains fragile. Should a deal not be reached and tariffs be raised further on US trade with China and Europe, we would expect the global economy to continue to slide, very possibly into recession in the quarters ahead (see "If the crosscurrents strengthen, how far could global growth fall? ").
- On the other hand, a surprisingly positive trade agreement, with a significant tariff rollback, would boost our outlook for global growth. Recent official chatter casts doubt on this outcome. While it could be a negotiating tactic, we see risks tilted more to the downside.

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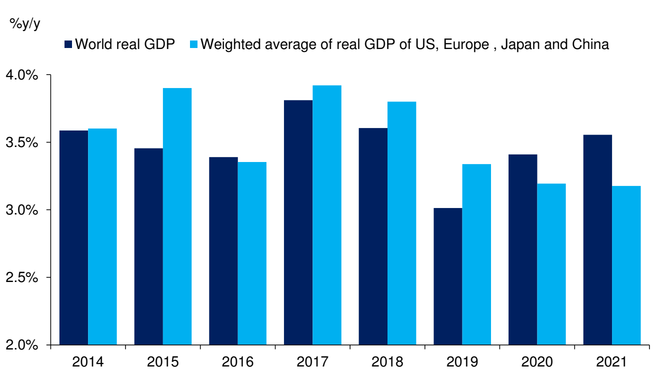
1. Introduction

The past year and a half has seen an impressive slide in the global economy. Global GDP growth is expected to have ebbed to its lowest rate since the great recession this year, with some regions nearing recession and others increasingly fearing it. The primary factor underlying this slowdown is the strongly depressing effect on global trade and investment that has resulted from sharp increases in economic policy uncertainty associated with both trade policy conflicts and Brexit.

In recent weeks and months, however, tentative signs of an easing or even ending of the downtrend in global growth have emerged. Financial markets have gotten a lift from both an easing of trade tensions and some more constructive developments on the Brexit front, with equity values boosted, credit spreads narrowed, and yield curves steepened. PMIs and other leading indicators of business activity appear to be forming a trough. Our view for some time has been that global growth would bottom by the turn of this year and begin to pick up gradually over the year ahead, albeit with significant downside risks attached to this baseline scenario.

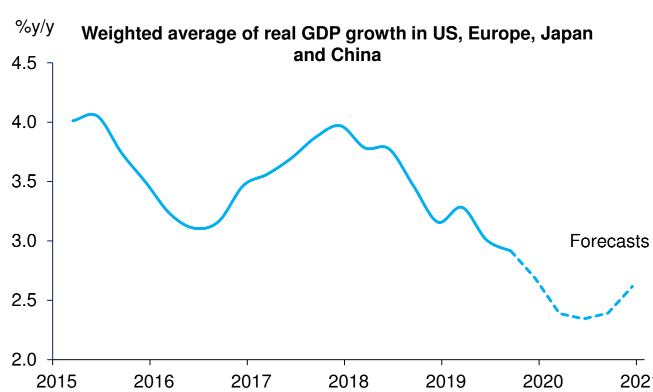
The purpose of this update is to sift through the recent evidence to determine whether our central expectation of a current bottoming is on track and to consider how the risks around that view may have shifted. Assuming the global economy is nearing a turning point, could we be too pessimistic in our perception that a current bottoming is fragile and our expectation of only a slow pickup in growth over the year ahead?

Figure 1: 2019 expected to mark the trough in global growth



Source : IMF, Haver Analytics, Deutsche Bank Research

Figure 2: Growth in several major economies has neared post-crisis lows



Source : IMF, OECD, Haver Analytics, Deutsche Bank Research

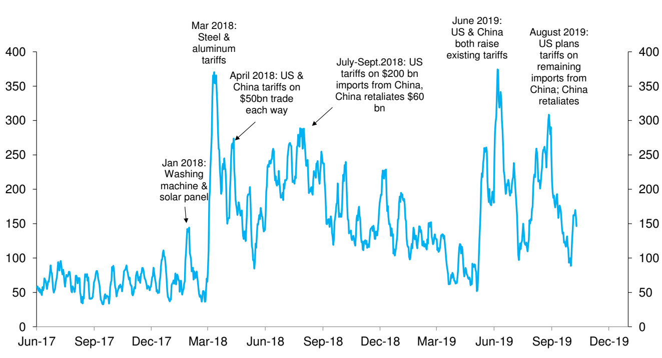
To address these issues, we begin by reviewing in Section 2 recent more favorable developments in the key headwinds to global growth, namely trade tensions between the US and China (and others) and the prospects for a disruptive UK exit from the EU. In doing so, we consider in particular empirical evidence of the extent to which key policy announcements have affected the level of policy uncertainty. In Section 3, we review global evidence, namely the recent behavior of leading indicators of global economic activity, including global PMIs and various measures of global financial conditions. This analysis does point to a near-term bottoming of global growth that should prove sustainable as long as risks related to trade policy and Brexit are resolved positively.

In the remainder of this piece, we turn to regional analysis, with a focus on the US, Europe, Asia ex Japan and Japan in Sections 4-7, respectively. In each of these sections, we focus on three questions: (1) Has the economy bottomed?, (2) Have recession risks been curtailed for the year ahead, and what risks remain?, and (3) How much upside is there from a greater easing of trade tensions than we have been assuming, for example, via a significant rollback of US tariffs? A global synthesis of these analyses and our conclusions are presented in Section 8.

2. Easing of the headwinds

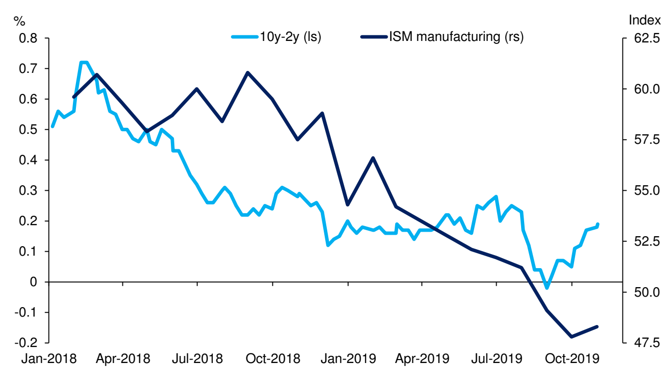
Recent developments suggest the global economy may have dodged a bullet in late summer, when the Trump Administration announced significant new tariffs on China with a response in kind by China, and simultaneously, developments in the UK appeared to push the likelihood of a no-deal Brexit above 50/50. The uncertainty created by these events weighed significantly on global trade and investment. The Fed staff's trade policy uncertainty index jumped during August on these developments (Figure 3). The stock market dropped, the US manufacturing ISM fell below 50, and a key conventional US yield curve slope (2s-10s) inverted for the first time since before the great recession, causing recession probability models to flash warning signals of elevated risk (Figure 4). Some major European countries were already in or near recession, and growth in China and the US was showing clear signs of slowing. However, although uncertainties remain, and risks of more adverse outcomes are still present, risks associated with both trade tensions and Brexit appear to have taken a turn for the better in early October.

Figure 3: Trade Policy Uncertainty index



Source : https://www2.bc.edu/matteo-iacoviello/research_files/TPU_PAPER.pdf , Deutsche Bank Research

Figure 4: Yield curve inverted more deeply and manufacturing sentiment took a step lower following August trade escalation



Source : FRB, ISM, Haver Analytics, Deutsche Bank Research

Trade tensions ease

On trade policy, the Trump Administration appeared to shift course when it announced on October 11 a tentative Phase I of a larger trade deal with China. The announcement included an indefinite delay of the scheduled mid-October tariff increase. We assume that a finalized Phase I deal would also remove or delay through next year the tariffs scheduled to be imposed in mid-December on remaining imports from China (mostly ITC equipment and other consumer goods). In exchange, China is expected to commit to larger agricultural purchases, rein in technology transfer, bolster protection of intellectual property, and commit to greater transparency on foreign exchange reserves with a commitment not to manipulate the currency market.

Our base case is that a Phase I deal along these lines will be signed, in part because the Trump Administration has a strong incentive to achieve at least a "truce" in the trade conflict to ease tensions and mitigate their depressing effect on the economy ahead of the approaching election. However, there are risks on both sides of this assumption. It is possible that China will seek a rollback of existing tariffs to agree to such a deal. The US Administration has sent mixed signals on the likelihood that it would go along with this condition. Should this prove to be a major sticking point, the deal could fall through and trade policy uncertainty remain elevated, yielding a worse outcome than we expect. Should the US agree to a rollback, the outcome could prove more positive than we expect.

In other very recent developments on the trade front, US Administration and Congressional officials (most notably Trade Secretary Ross and Senate Finance Committee Chairman Grassley) have indicated that prospective tariffs on imports of autos from Europe and elsewhere will be delayed or dropped, though no official announcement has been made. This news and the easing of US-China trade tensions have been reflected in movements in trade policy uncertainty, which has receded from the early August highs. While still somewhat elevated, the recent "uncertainty" this index captures has been generated by favorable news rather than unfavorable news.

Brexit risks diminish, but do not disappear

Hopes for a positive Brexit outcome improved when new UK Prime Minister Boris Johnson renegotiated the Withdrawal Agreement with the EU by adopting a Northern Ireland-only backstop. Although the Government won a vote on the second reading of the Withdrawal Agreement Bill in Parliament, a procedural motion was subsequently lost, and to break the impasse a general election on 12 December was called. Most polls point to a comfortable Conservative majority, which would lead to ratification of Johnson's Brexit deal before the 31 January deadline. However, two issues still create risk.

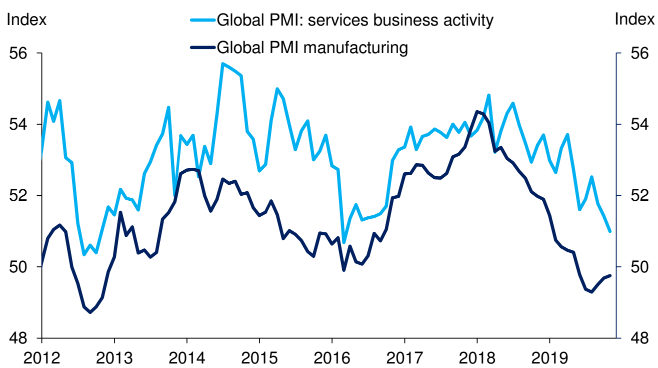
First, even if Johnson's deal is ratified in January, the UK could still crash out of the EU at the end of 2020 unless an FTA is agreed (the 'deal' only secures transition). This means another Brexit cliff edge will occur in June 2020 when a decision must be made on an extension of the transition period beyond December 2020. In our view, it would be next to impossible for the UK and EU27 to agree to even a simple FTA in the next 12 months. As such, our base case is that a Conservative majority would likely result in a longer-term extension of the transition period. If so, the uncertainty about the future relationship between the UK and EU could linger.

Second, the size of the Conservative majority will have important ramifications. The larger the Conservative majority, the less dependent Johnson will be on hard Brexit MPs and the more the door opens to a closer economic partnership with the EU than the one suggested in the current draft of the future relationship. Conversely, the smaller the Conservative majority, the greater the risk of a more distant economic relationship.

3. Global evidence: PMIs and financial conditions

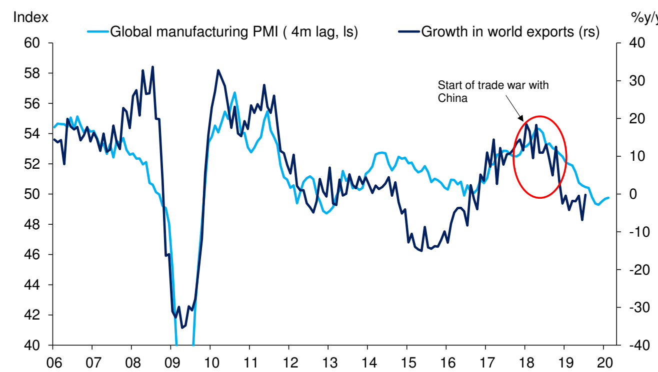
After experiencing a relentless decline between late 2017 and mid-2019, the global manufacturing PMI has shown incremental improvement recently, rising in each of the last three months. While the initial rise in the PMI in August preceded the de-escalation in trade tensions as just outlined, it was likely helped by the previous easing of financial conditions driven by dovish expectations and actions by global central banks. As trade policy uncertainty then ebbed from its peak in August, easy financial conditions and some trade tension relief combined to provide further support for global manufacturing sentiment over the past two months. If sustained, the uptick in global manufacturing sentiment could presage an upturn in global trade flows, given the leading relationship for the former.

Figure 5: Global manufacturing sentiment has ticked up in recent months



Source : IHS Markit,Haver Analytics, Deutsche Bank Research

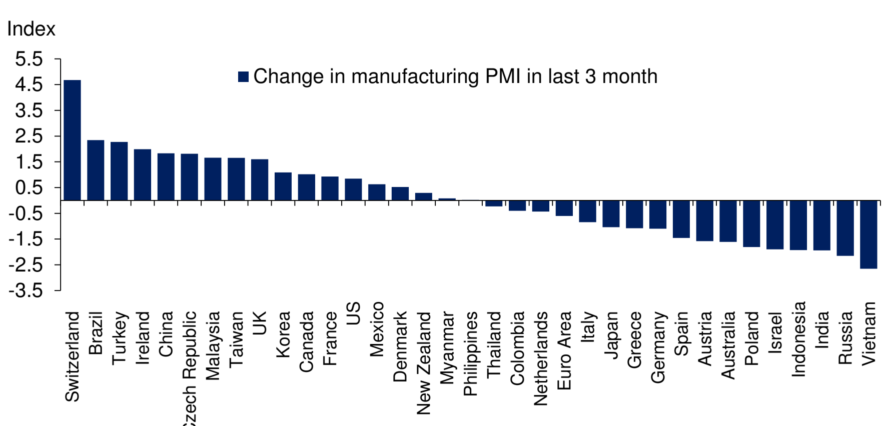
Figure 6: Sentiment turn should presage bottoming of global trade



Source : IHS Markit, IMF, Haver Analytics, Deutsche Bank Research

The cumulative rise in recent months, from 49.3 to 49.8, is no doubt modest, and the index remains below the important 50 demarcation, but it nonetheless marks a noticeable and semi-persistent pivot from the prior relentless decline. This improvement has not been uniform across countries, as many economies have continued to experience falling manufacturing sentiment in recent months. Conversely, global services sentiment has not yet shown evidence of bottoming, which has pushed the global composite PMI to near the lowest point since the global financial crisis.

Figure 7: Diverse manufacturing PMI experiences in recent months

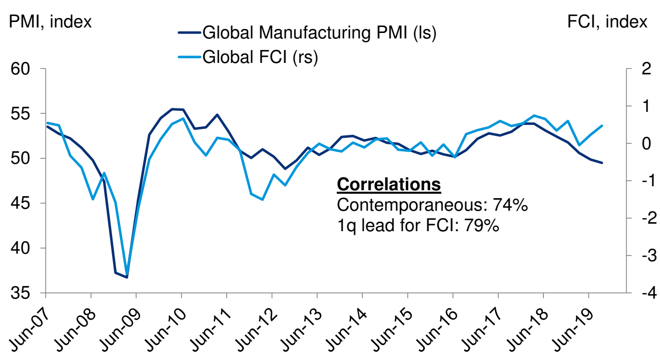


Source : IHS Markit,Haver Analytics, Deutsche Bank Research

Is the incipient turn in global manufacturing sentiment a false dawn or has global growth momentum convincingly passed the trough? A few pieces of evidence suggest that the bottoming is likely sustainable and that we are at, if not past, the trough, even if the upside from here may be limited.

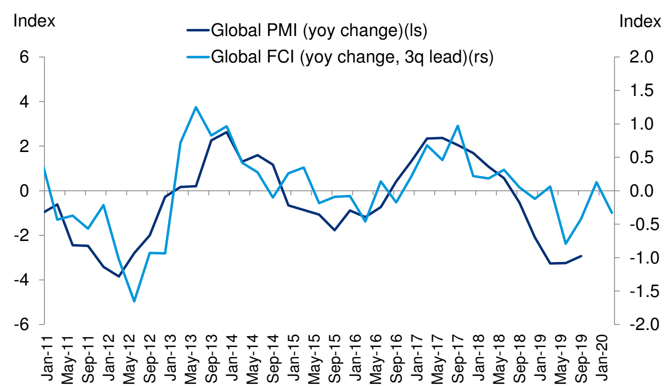
First, our global financial conditions index (FCI) indicates that there is some modest upside to the global PMI in the next few quarters.[1] According to the leading relationship between our global FCI and the global PMI, in both level and change terms, the latter has upside to an above-50 level in the next few quarters. While the recent gap between the two series gives a reason to be cautious about confidently extrapolating this relationship, we think the divergence is at least partly due to the effects of global trade policy uncertainty, which has depressed manufacturing sentiment despite central banks' successful efforts to ease financial conditions

Figure 8: Global manufacturing PMI and FCI track closely



Source :IHS Markit, Haver Analytics, Deutsche Bank Research

Figure 9: Financial conditions point to some modest but sustained PMI upside

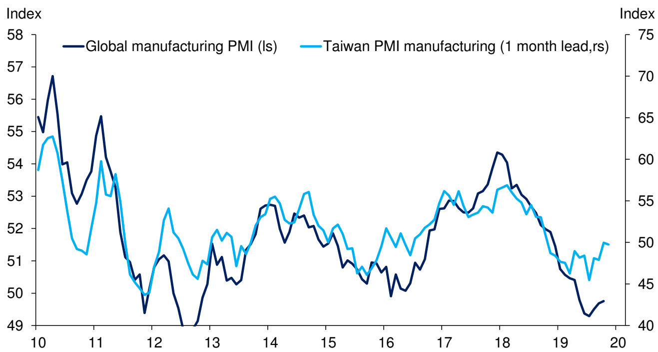


Source :IHS Markit, Haver Analytics, Deutsche Bank Research

Second, various indicators, which have demonstrated modest leading properties for global manufacturing sentiment, are consistent with some modest further upside. For example, the Taiwan manufacturing PMI and the short-term trend in Korea semiconductor exports point to a further near-turn upturn in the global PMI.

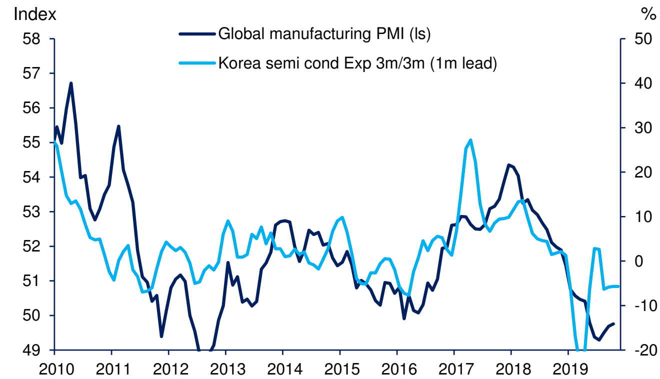
1 Our global FCI is constructed as a GDP-weighted aggregate of our FCIs from US, China, euro area, UK and Brazil, and it has been a reasonably good leading indicator for turning points in the global manufacturing PMI during this cycle. In particular, the year-over-year change in our global FCI has led the year-over-year change in the global PMI by about three quarters since the crisis, with a correlation of more than 60%.

Figure 10: Taiwan manufacturing PMI points to some global upside



Source :IHS Markit, Haver Analytics, Deutsche Bank Research

Figure 11: Semi conductor exports have come off the bottom in recent months



Source :IHS Markit, Bank of Korea, Deutsche Bank Research

Third, and more speculatively, progress towards de-escalation in trade tensions, if confirmed, should provide an incremental lift to sentiment and global trade. Recent positive news flow related to the section 232 investigation into global auto tariffs and negotiations with China indicate that we may be past peak trade tensions. Confirmation that this is indeed the case, and a firmer commitment to reduce trade policy uncertainty, would provide an additional lift to global growth momentum. If our expectations are correct that global auto tariffs are delayed or taken off the table, a Phase 1 deal is passed, and no further tariff measures are implemented, it seems more likely that global growth momentum has bottomed.

The global view just presented suggests that manufacturing sentiment has likely passed the trough. And given the leading relationship with global trade flows, this would suggest the same is true for global trade. In the next few sections we take a regional view of this question.

4. US: Close to the trough with fewer downside risks

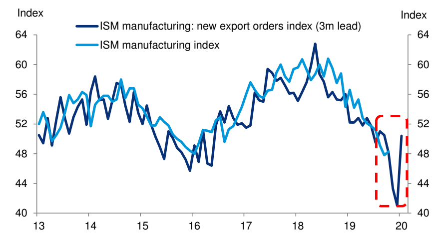
Growth momentum close to bottoming

With trade policy uncertainty and sputtering global growth depressing capex and net exports, growth momentum has continued to slow in the US. However, momentum has thus far been more resilient than feared, with sturdy consumer spending continuing as the primary, consistent pillar of growth. A sustainable turn in growth momentum in the US requires a reversal of the drags from capex and trade coupled with continued consumer strength.

Data in hand suggest that we have not yet hit the bottom in US growth, though that point could be near. While the ISMs and PMIs, overall, have not yet signaled a trough in activity and a sustainable upturn, leading and contemporaneous indicators have, on balance, been somewhat more supportive. For example, new export orders have been a reliable leading indicator for the ISM manufacturing index and capex over this cycle. Having plunged to dire levels this summer, new export orders recently surged back, a development which, if it is sustained, points to a stabilization and modest upside in the ISM in the coming months. Regional Fed surveys, though mixed, are also on balance consistent with being past the trough in US manufacturing sentiment.

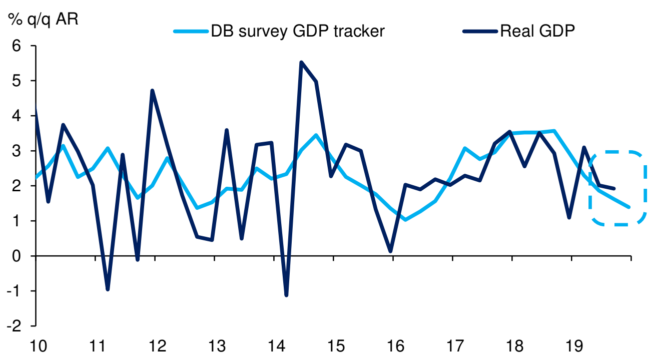
Two of our proprietary tracking tools suggest that US growth momentum is likely set to bottom around the turn of the year. Our survey GDP tracker, which distills the signal from a large set of US survey data into a single growth indicator, suggests that Q4 growth should be near 1-1/4%, consistent with our official forecast. But as just noted, incremental news on this front has been more positive. This metric has been a better measure for underlying growth momentum than what can be volatile quarterly fluctuations in GDP. Meanwhile, our momentum index, which is constructed from our top fifteen leading indicators for growth, indicates that growth should slow through Q4 but should begin to rise modestly into Q1.

Figure 12: New export orders snapped back, suggesting less downside to ISM



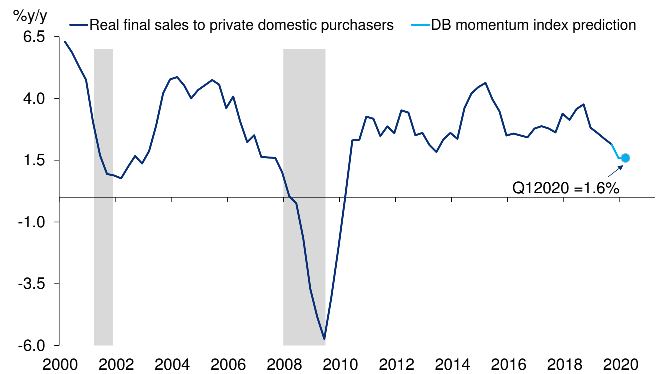
Source :ISM, Haver Analytics, Deutsche Bank Research

13: Survey GDP tracker points to weakening growth into Q4 2019



Source : BEA, Haver Analytics, Deutsche Bank Research

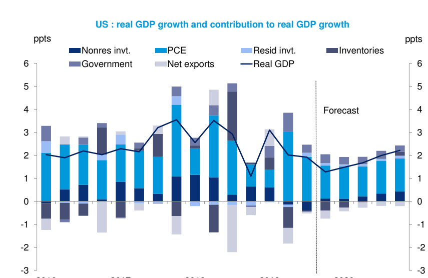
Figure 14: But DB Momentum Index consistent with a stabilization into Q1 2020



Source : BEA, Haver Analytics, Deutsche Bank Research

These signals are consistent with our forecast which calls for real GDP growth to bottom at 1.3% annualized this quarter, move higher in Q1 2020 to 1.5%, and then nudge sequentially higher through end-2020. A confirmation that US growth momentum is past the trough will require confirmation that trade tensions will not escalate further. An agreement on a compromise resembling the tentative Phase I deal would be sufficient. However, if trade tensions escalate further, particularly with the December tranche of tariffs that target key consumer goods going into effect, growth momentum would be likely to slow meaningfully further.

Figure 15: US growth expected to bottom in Q4 2019 as capex begins to recover

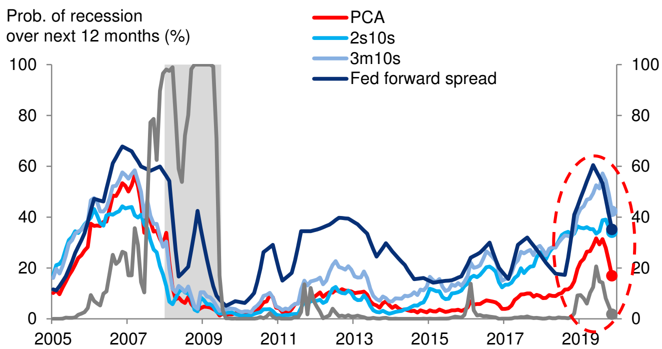


Source : BEA, Haver Analytics, Deutsche Bank Research

Recession risks curtailed if trade tensions dissipate

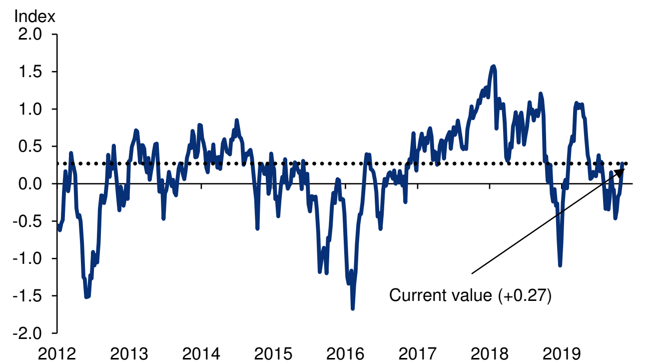
Over the past month, all metrics we track to gauge recession probabilities have pointed to reduced risks. All popular yield curve slope recession indicators have steepened and financial conditions have eased. More fundamentally, the sharp slowdown in jobs and aggregate hours worked in the first half of 2019, which alerted us to downside risks to consumer spending, has also abated somewhat. Less-worrying jobs and income prospects are consistent with reduced recession risks — consumer spending growing 2% or more provides a meaningful buffer against an intensification of headwinds from capex and trade.

Figure 16: Market-based measures of recession probabilities over the next year have dropped



Notes: The dots represent probabilities from the most recent daily data. Source : Deutsche Bank Research

Figure 17: Financial conditions have bounced back to positive (growth-supportive) levels



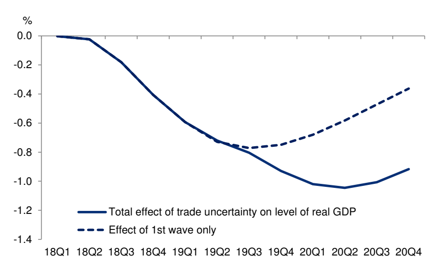
Source : Deutsche Bank Research

Behind the turn in market-based measures of recession probabilities is no doubt progress made towards reducing downside tail risks from trade tensions and Brexit. We have emphasized the recession risks from a full-blown trade war in past work (see " If the crosscurrents strengthen, how far could global growth fall? "). In particular, we saw implementation of the December tariffs and failure to remove the uncertainty from global auto tariffs as risking a mild recession scenario in the US. While uncertainties remain, risks that these events deteriorate and trigger a sharper downturn have diminished. When coupled with a more resilient picture for the US consumer and labor market, we concur with market signals that US recession risks over the next year have lessened.

Modest upside from tariff roll back

As noted in Section 2 above, the assumptions underlying our current baseline forecast are in line with the most likely content of the Phase I agreement with China, plus the US taking auto tariffs off the table. A rollback of existing tariffs would be a step further in a constructive direction than we have assumed. Various studies suggest that the tariffs in effect as of July 25, 2019, are depressing US real GDP by 0.3 percent. Indeed, the IMF has estimated that the tariffs would reduce global GDP in 2020 by 0.5 percent. Therefore, a scenario whereby the 15% tariff on Stage 4A goods ($125 billion of US imports from China) is eliminated and corresponding Chinese tariffs on $25 billion of US exports is dropped could add roughly 10 - 20 bps to our forecast for 1.8% (Q4/Q4) US growth in 2020. This gain would mostly be due to improved capital spending and a small boost to exports as business sentiment improves following the removal uncertainty. A more substantial upside surprise would be a defined path to reduce US tariff rates on Stage 1-3 goods ($240 billion), with China also making similar commitments to reduce the 5%-25% tariff rates that it has imposed on various US exports of roughly $90 billion. A complete removal of trade policy uncertainty could provide a more meaningful uplift to US growth. Indeed, recent work by Fed staff found that recent spikes in trade policy uncertainty are reducing US GDP by around one percentage point.[2]

Figure 18: Impact from trade policy uncertainty on level of US GDP



Source : Caldara et al. (2019), FRB, Deutsche Bank Research

However, downside risks are present as well. If talks between the US and China collapse, tariffs are raised by both sides on December 15, and the US also takes action on auto imports more broadly, the US and global economies could be pushed

2 See Caldara et al. (September 4, 2019), "Does trade policy uncertainty affect global economic activity?" FEDS Notes.

into recession, as we have noted.

5. Europe: why it might be on the cusp of an upgrade cycle

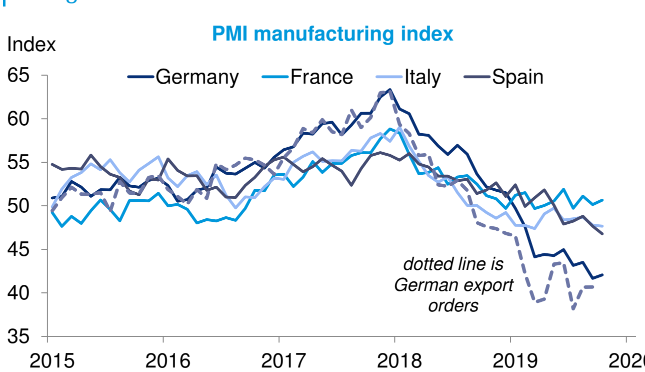
First, the manufacturing data, particularly in Germany, are beginning to bottom. Foreign orders are volatile month to month but are going sideways at worst after weakness at the start of the year. The German manufacturing PMI increased in October. Within the detail, orders were up with export orders the highest for four months and above the 2019 average[3] . German GDP growth exceeded expectations in Q3. GDP expanded by 0.1% qoq, two-tenths more than the consensus forecast, thus avoiding a technical recession. Our euro area data surprise indicator (*SIREN-Surprise*) has turned positive for the first time in 20 months.

The turning point is tentative – at 42.0 the German manufacturing PMI is still the second lowest of this cycle and the IP data are consistent with another manufacturing contraction in Q3 – and needs confirmation. The gap between PMI new orders and inventories, which had fallen sharply, is rebounding more rapidly in the euro area than in Germany. That could be consistent with lingering structural weakness in the German auto sector.

Second, the tone around the political issues that explain the sharp rise in economic uncertainty this year has begun to improve – with regard to trade war, auto tariffs and Brexit[4] . The rise in uncertainty this year, when factored into our models, implies the risk of recession has risen to about 40%[5] .

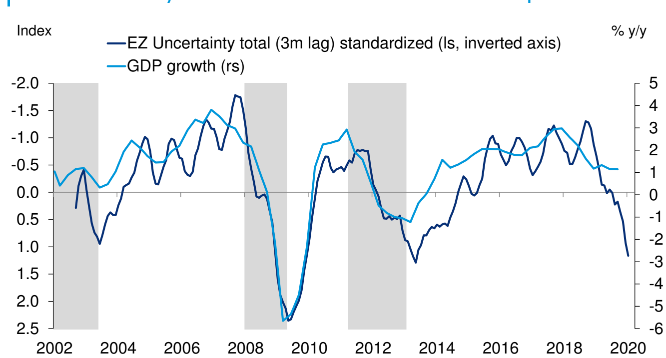
If the improving tone holds and the risks do not materialise, the rise in uncertainty should begin to reverse. A reversal of the rise in uncertainty would help defuse the threat of pass-through of heightened uncertainty into domestic demand via capex and the jobs market[6] .

Figure 19: Signs of emergent stability in German manufacturing indicators



Source : IHS Markit, Haver Analytics, Deutsche Bank Research

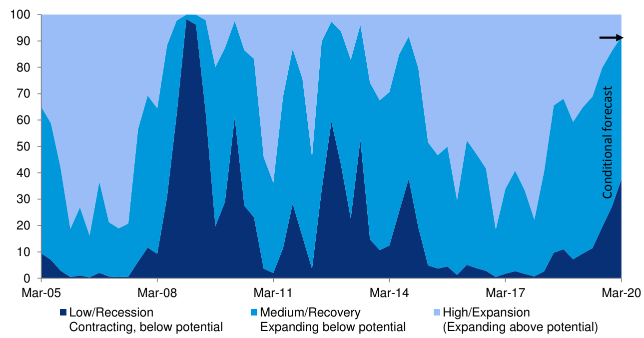
Figure 20: If trade war and external risks dissipate quickly, an uncertainty shock could be avoided in Europe



Source : Eurostat, EC, Macrobond, Deutsche Bank Research

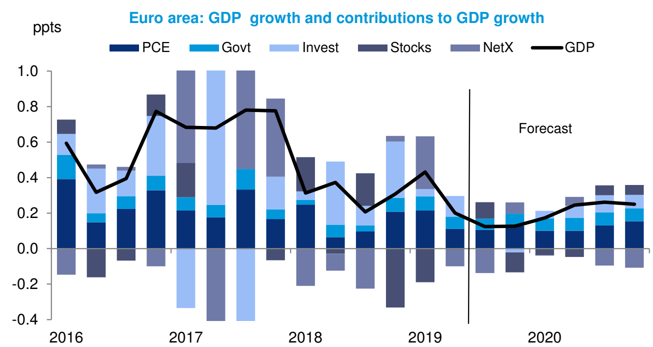
3 The proportion of countries globally reporting a PMI export orders index above 50 (expansion) has increased from 29% in September – the lowest since the global financial crisis – to 43% in October.
4 "Economic uncertainty: rising and spreading", DB Focus Europe , 23 October 2019.
5 "Cycle Dashboard: Domestic demand resilence cannot be taken for granted", DB Focus Europe , 30 October 2019.
6 "Brace for impact: uncertainty and the labour market", DB Focus Europe , 11 October 2019.

Figure 21: Rising uncertainty has pushed the risk of recession to 40%



Source : Deutsche Bank Research

Figure 22: Our moderate euro area growth baseline for 2020 could be upgraded if the trade and external risks dissipate



Source : Eurostat, Haver Analytics, Deutsche Bank Research

Our 0.8% euro area GDP growth forecast for 2020 assumes a Brexit deal and no escalation in trade war (e.g., no auto tariffs). In a direct sense, confirmation of a Brexit deal and/or the avoidance of an escalation of trade war (including auto tariffs) should not boost growth expectations. However, **we see two bases on which upward revisions could become possible.**

One basis would be a rapid and substantial reversal of uncertainty. Our baseline expectation is that risks do not materialise. However, uncertainty has also dampened activity, in our view. Using ECB elasticities, the rise in uncertainty over the last 12 months could have reduced growth expectations by c.0.5pp. If we assume uncertainty reverses half its rise, there would be scope to add 0.2-0.3pp to 2020 expectations. Our baseline assumes some decline in uncertainty as trade tensions and Brexit risks subside somewhat. Therefore, a rollback in US tariffs on US-China trade could lead to a more rapid reversal in uncertainty.

There are reasons to believe that uncertainty won't completely reverse its rise. First, a Brexit deal only secures a stand-still transition. Hard Brexit is still possible at the end of 2020 unless the UK applies for a two-year extension of the transition period by the middle of 2020. Transition avoids near-term downside risks from materialising, but the uncertainty around the future relationship between the EU and UK limits the upside, in our view. Second, we think it unlikely that global corporate confidence in cross-border business activity and trade will return to where it was prior to the trade war. There may be some catch-up investment if trade war risks, etc. do not materialise, but we do not expect a full normalisation of conditions.

The other basis for an upgrading of European growth expectations would come from the global growth cycle. Resolving political uncertainties could prompt a global growth cycle. An upgrading of external demand expectations would lift euro area exports, investment and employment. A 1% increase in global growth should lift euro area GDP by 0.3-0.4%. We were conservatively assuming a further slowing in global growth in our 0.8% baseline. Marking the global growth assumption to current expectations alone would add 0.1-0.2pp to our 2020 forecast. Outright upgrades to the house view on global growth would have an even more positive impact. There would be no funding constraint on growth. A revival in euro area demand in H1 2020 would make it easier for banks to satisfy the lending benchmark and take full advantage of the new and more generous TLTRO3 terms, for example.

Two issues could affect the elasticity of euro area growth with respect to global growth. First, the stronger is global investment spending, the stronger should be global trade growth. If global uncertainty reverses and global investment spending accelerates, the rise in trade should benefit Europe. Second, the stronger is global auto demand, the stronger global trade should be also. This is because of the auto sector's long and complex cross-border supply-chains. Stronger global growth should spill over into auto demand and be positive for Germany and, by extension, the euro area. However, with Europe's CO2 regulations getting gradually tighter, the auto production outlook is getting increasingly clouded. The risk is the auto sector makes a smaller-than-normal contribution to a recovery in global trade.

Even in the event of export-led cyclical upgrades to euro area growth, we would be cautious about extrapolating the impulse far. There are some potential speed brakes. Fiscal policy is one. If growth surprises to the upside, not only will the impetus to ease fiscal policy decline, but the push to comply with the rules and build buffers for the next downturn will intensify too. Macro-prudential policy is another. European central bankers are becoming more vocal about pockets of excess credit creation. Increasingly counter-cyclical capital buffers can be a blunt too to manage this.

Finally, the euro area still faces some fundamental challenges. First, the inflation environment remains soft. The pass-through from wage inflation to consumer price inflation has been slow. It will take a persistent strong recovery to build confidence in inflation normalisation. The monetary policy stance can be expected to remain accommodative — and become increasingly burdensome for bank — and any new downside shocks would be a challenge for the ECB given the lack of room for manoeuvre. Christine Lagarde's challenge at the ECB is to convince EU leaders and finance ministers that they need to unburden monetary policy with fiscal policy[7] .

With risks beginning to tilt towards growth upgrades, the pressure on the ECB to ease the monetary policy stance further is unwinding. There would need to be a persistently strong growth performance, with spillover into core inflation, to think that monetary policy exit becomes relevant. More likely is an extended period of unchanged policy, certainly through the next year.

Second, divergence between member states is a key structural vulnerability. Without investment in a more domestic business model and policies to promote real economic convergence, the risk is a stagnation trap. How to avert this is Ursula Von Der Leyen's challenge at the European Commission. Climate change policy could be the conduit to large public investment. However, the green debate is also creating frictions and uncertainties – for example, whether the EIB should cease investment in non-renewal energies when they are still economically important to some member states, including Germany[8] .

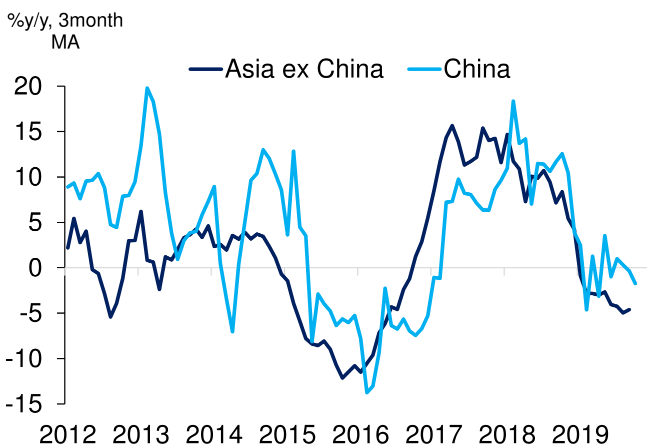
6. Asia: possible lull in a secular growth downtrend

Asia has been hard hit by the US/China trade war and so any positive developments on that front would be especially good news for this region. The September 2018 tranche of US tariffs was especially damaging to the region as it impacted $200bn of Chinese exports, more than three times the amount impacted previously and

7 "ECB Preview: (dis)continuous monetary policy", DB Focus Europe , 18 October 2019.
8 "How to avoid a stagnation trap", DB Focus Europe , 20 August 2019.

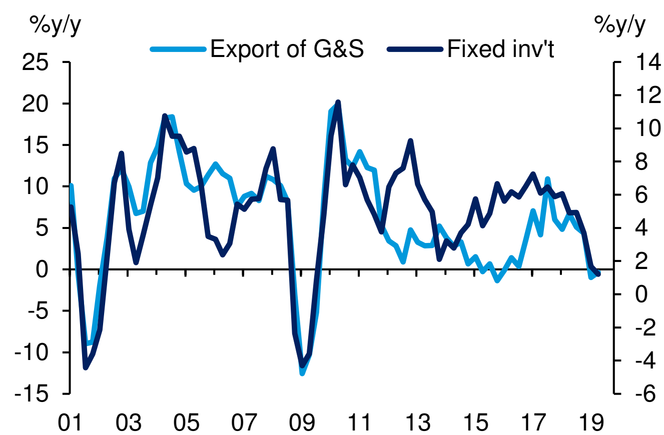
rebounded strongly on supply chains throughout the region. Including China, Asian export growth slowed from 9.1%yoy growth in 2018Q3 to -1.1% by 2019Q1 and -2.7% in both Q2 and Q3. Chinese export growth slowed from 11.7% to -0.4% over those four quarters but exports from the rest of Asia have fallen significantly faster over the past year (Fig 23).

Figure 23: China and Asia ex-China exports



Source : Haver Analytics, Deutsche Bank Research

Figure 24: Asia ex-CH, IN real exports and investment



Source : Haver Analytics, Deutsche Bank Research

For the region's small open economies, the loss of export growth over the past year has been matched by a decline in investment growth (Fig 24). This is typical of this region – exports dominate other cyclical influences. In that sense, 2012-15 was the aberration – previously, and since 2016, exports and fixed investment have been highly correlated.

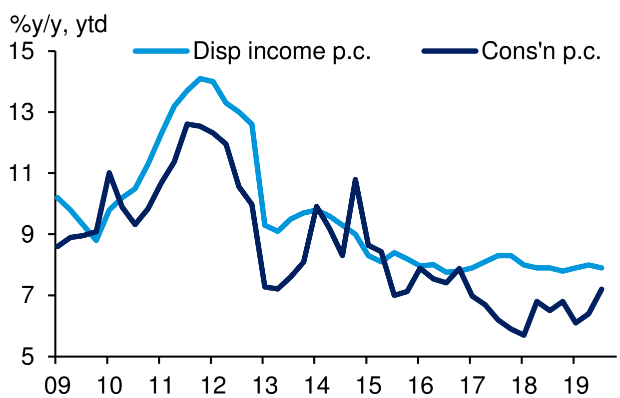
Assuming no further increase in tariffs, we expect Asian exports – including from China – to rise to modestly positive growth by the end of next year, reflecting the growth in Asia's key export markets – the US and Europe – and the absence of new restrictions. If the tariffs were to be completely removed as part of any US/China agreement, Asian export growth could be closer to 10% by the end of next year.

In the baseline scenario of no new tariffs, and especially if tariffs are removed, we would expect the recovery in export growth to be reflected in a recovery in investment growth. Higher export growth and higher fixed investment growth would be reflected as well in higher imports. Consumption growth has been much less obviously pro-cyclical in recent years than was the case prior to 2009, but it's not unreasonable to expect that if exports are growing and firms are investing more, they may be hiring more. So some of the recovery in exports and domestic demand should "leak" in the form of higher imports. Our current forecasts have regional growth – currently about 3.6% for Asia ex-China and India – slowing slightly until Q2 (3.4%) and ending next year at close to 4%.

One source of upside risk to this outlook is the cycle, which may already be turning. As was noted above (Fig 11) the semiconductor cycle may have bottomed and the rollout of 5G could add to the recovery in the sector. To some extent, this cycle may be independent of trade war concerns – it peaked in mid-2017, for example – so it may be an independent source of upside risk to the Asian economic outlook.

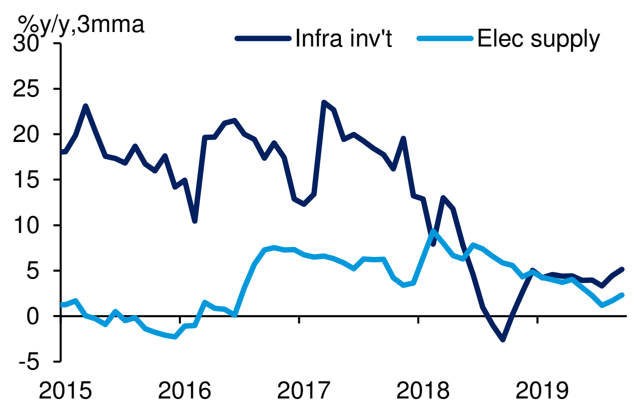
For most countries, recent data don't yet point to recovery in growth. But there are some signs of a bottoming of domestic demand in China. Most of the decline in retail sales growth in China over the past couple of years reflected a rise in the household savings rate. Household income growth hadn't slowed—it's been about 8%yoy for the past five years – but consumption growth slowed to about 6.5% since 2017 (Fig 25). But it looks like consumption growth may have bottomed as the propensity to consume recovers. Infrastructure investment growth rebounded late last year as the government relaxed credit constraints on local governments. Electricity generation also looks to have rebounded in the last couple of months.

Figure 25: Per capita income and consumption in China



Source :WIND, Deutsche Bank Research

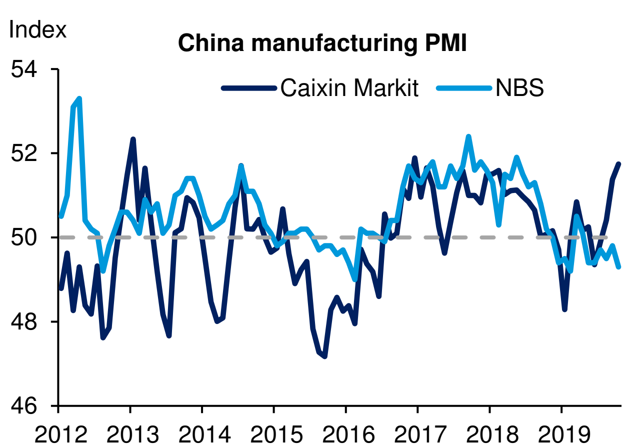
Figure 26: Infrastructure investment and power supply



Source : WIND, Deutsche Bank Research

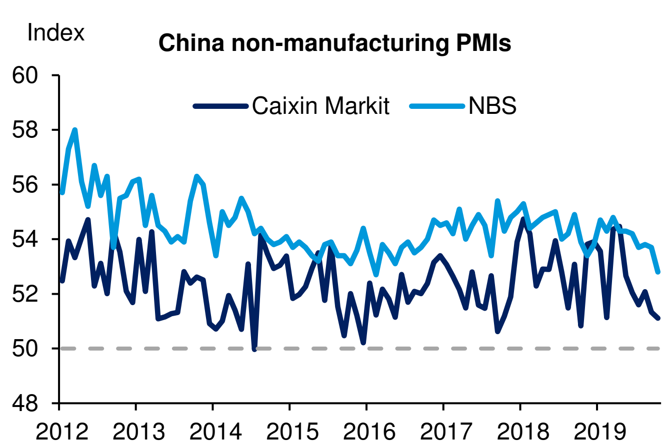
The most encouraging signal to come out of China is the sharp rise over the last couple of months in the Caixin-Markit manufacturing PMI index to its highest level since early 2017. The new orders index, the most forward-looking part of the survey, was at the highest level in October since January 2013. The NBS' broader PMI doesn't show the same ebullience, though, and both surveys' indexes of activity in non-manufacturing sectors continue to point downwards.

Figure 27: Manufacturing PMIs



Source : Haver Anlytics, Deutsche Bank Research

Figure 28: Non-manufacturing PMIs

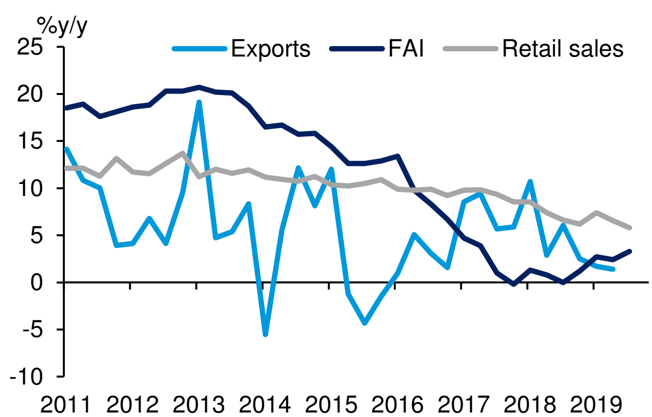


Source : Haver Anlytics, Deutsche Bank Research

But there's reason to believe, we think, that if Chinese export growth rises over the coming year – in the absence of new US tariffs, exports to the US would cease to be a drag on total export growth, which might end next year up a few percent – then investment in export-oriented manufacturing activities might also strengthen. That is, the dynamic we see in the rest of East Asia shown in Fig 24 above, likely holds for the export sector in China.

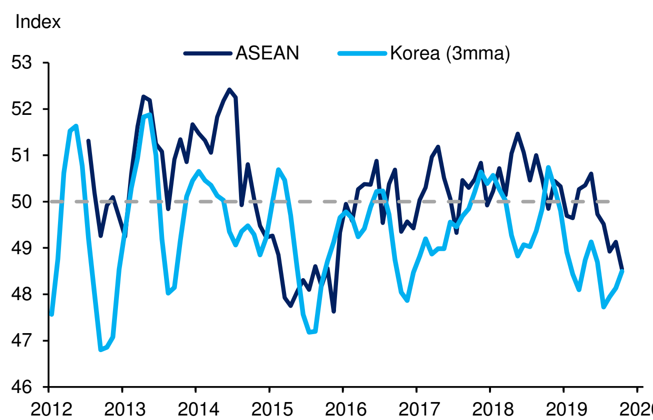
If it does, then we may see in 2020 a revival in export growth and a revival in private manufacturing investment but a decline in infrastructure investment growth. As Fig 29 below suggests, the government has used infrastructure as a counter-cyclical policy tool – constraining investment when export growth revived in 2016-17 and stimulating it in 2018 when export growth slowed. Thus, a revival of exports may be less of a stimulus to GDP growth in China than in neighbouring countries. But the possibility that consumption growth could be higher – not yet our baseline expectation – offers perhaps some upside risk to the outlook for China. As it is, we expect GDP growth to be a little firmer in Q4 than it was in Q3 (6.1% vs 6.0%) but to slow to 5.9% next year

Figure 29: Real retail sales, exports and FAI in China



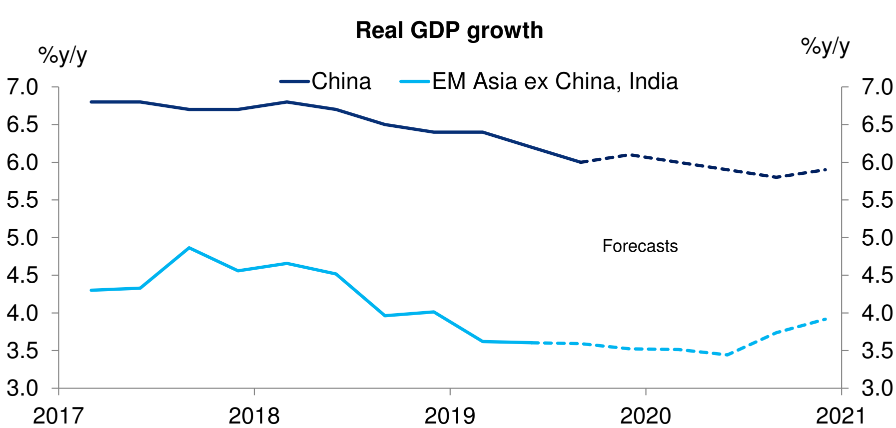
Source :Haver Analytics, Deutsche Bank Research

Figure 30: Manufacturing PMIs in Korea and ASEAN



Source :Haver Analytics, Deutsche Bank Research

Figure 31: Growth projections for China and Asia



Source : CNBS, National Sources, CEIC, Deutsche Bank Research

This outlook is not without risks. A near-term obstacle is the divergence of consumer and producer inflation. CPI inflation has risen to nearly 4% while PPI is getting deeper into deflation. This puts the PBoC in a delicate position as it needs to balance the conflicting goals of anchoring inflation expectations and supporting growth. Another downside risk is from the property sector. Property investment was surprisingly strong during the recent slowdown, but is unlikely to stay strong next year as lending to the property sector has been tightened further.

Taiwan is a positive outlier in the region. GDP growth seems already to have bottomed at the end of 2018 as firms there responded to the threat of US tariffs on their exports from mainland China by moving production back to Taiwan – fixed investment there has surged over the past year. And as trade war concerns have eased since late summer, the manufacturing PMI has risen to its highest level in a year, although still below 50 (see Fig 10 above).

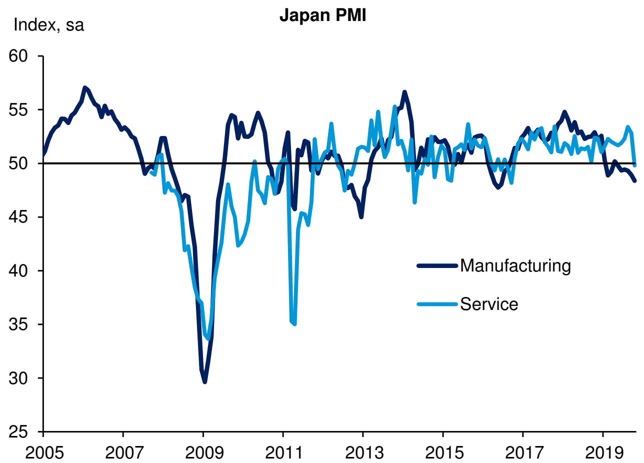
But elsewhere in Asia, the data continue to reflect the current depressed level of activity. The Korean PMI has rebounded somewhat in recent months but hasn't obviously broken out of the downward trend. Retail sales, construction and investment look to be stabilizing – coincident economic indicators are moving sideways – so the PMI may give an unduly negative perspective. ASEAN PMIs are still falling sharply. As we observed above, all of this can be expected to turn around quickly, in our view, if further tariff increases are avoided – even more so if US tariffs are lowered.

We have left India out of this discussion deliberately. India's slowdown – from 8% growth in the first half of last year to 5% in the April-June quarter – is mostly, we think, due to the difficulties in the financial sector. Asset quality deterioration in the commercial banking sector led to a decline in lending in 2016/17, which looked to be ending in 2018 as credit growth rose. But it has been slowing over the past year as concerns about credit risks in the non-bank sector have emerged. Overall, credit conditions have tightened and despite 135bps of rate cuts by the RBI, don't seem to have eased significantly. While we think growth has bottomed, it could be a very shallow trough without greater efforts to recapitalize financial intermediaries.

7. Japan: Unlikely to bottom before 1Q 2020 due to tax-related slump

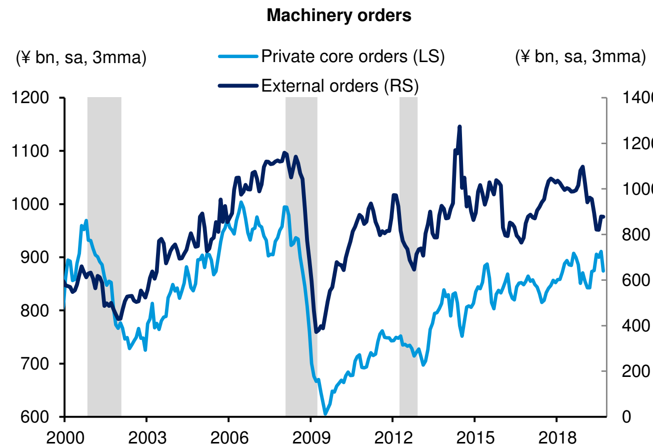
Economic activity at Japanese manufacturers has weakened amid the slowdown in overseas economies: the falloff in exports, especially to Asia, has become a negative factor for growth. Japan's manufacturing PMI has remained below 50 for six straight months, and the large manufacturer sentiment diffusion index in the BoJ's quarterly Tankan survey has declined for three quarters running. At the same time, both Asia-bound exports and overseas machinery orders, a leading indicator for capital goods exports, show signs of bottoming. Similarly, the slide in Chinese industrial machine tool orders looks finally to be reaching an end.

Figure 32: Japan PMI indexes



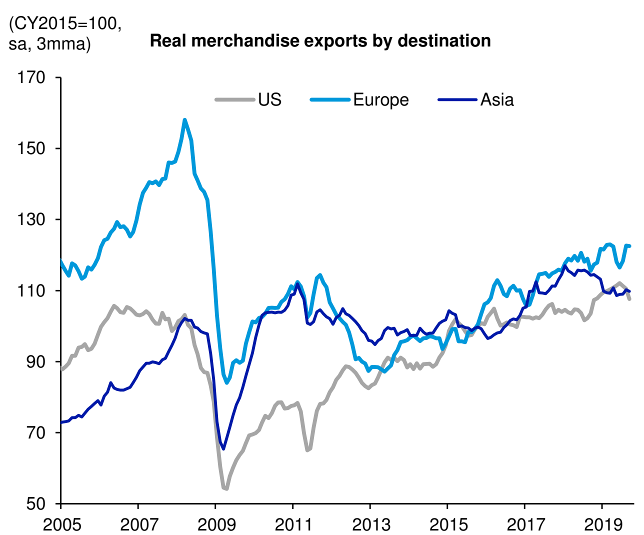
Source :Haver Analytics, Deutsche Bank Research

Figure 33: External machinery orders show signs of bottoming



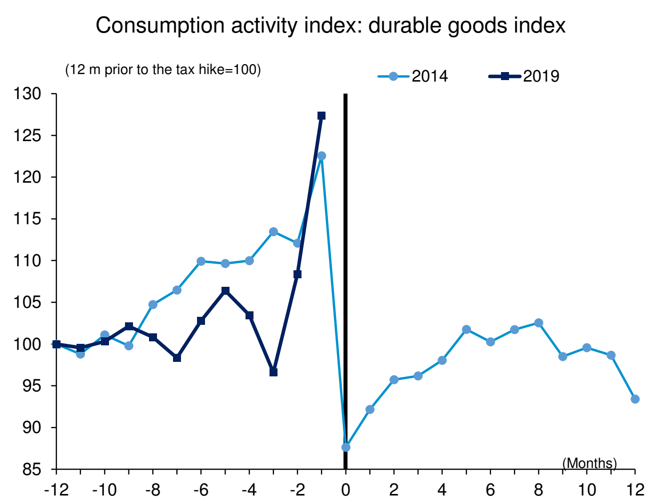
Source :Haver Analytics, Deutsche Bank Research

Figure 34: Real merchandise exports to Asia from Japan are stabilizing



Source : MoF, Deutsche Bank Research

Figure 35: Front-loaded demand prior to the consumption tax hike



Note : Zero denotes the month of consumption tax hike

Source : JFC, Cabinet Office, BoJ, METI, Deutsche Securities,Deutsche Bank Research

Furthermore, economic activity at non-manufacturers has until recently remained steady despite the overseas headwinds. The robustness in capex demand at non-manufacturers particularly has more than offset the sluggishness at manufacturers, attributable largely to demand for labor-saving investment in the face of tight labor supply/demand conditions. Such investment is not sensitive to the business cycle and should continue to underpin domestic demand.

Domestic demand has been firm in spite of the slump overseas, and the prospect of a turnaround in overseas economies is naturally a boon for the Japanese economy. That said, there is a chance that the nation could lag the recovery abroad due to the Japan-specific factor of October's consumption tax hike. The tax was raised by two percentage points, which is smaller than the three-point increase when the tax was last lifted in 2014. Additionally, we estimate that government measures to alleviate the effects, such as a special lower tax rate for certain items and a special point reward system, reduced the degree of pre-tax front-loading demand compared to 2014. However, durable goods sales appear to have been pulled forward as much as in 2014 and we may be under-estimating the effect of the tax increase. Note that the services sector PMI for October, measured after the consumption tax hike, fell sharply to 49.7, the first observation below 50 since September 2016. In addition to the tax increase, this likely reflected the severe typhoon that hit Japan last month.

Even as other central banks in major economies have become more accommodative in response to the global slowdown, the BoJ is holding firm on its current policy. It justifies this by noting that the retreat in overseas growth has not significantly impacted domestic demand. We believe the BoJ will maintain this stance even after the tax hike and avoid further easing action. We expect the government to come under strong pressure for stimulus measures. Prime Minister Shinzo Abe has already called for a new economic stimulus package and supplementary budget, and the various ministries are considering concrete steps. By the normal pattern, the supplementary budget will be approved by the Cabinet in mid-December. The supplementary budget over the past two years has been ¥2-3trn, but we expect something closer to ¥5trn in FY2019, focused mainly on disaster relief and reconstruction. The massive typhoons of September and October highlighted anew the need for infrastructure investment in Japan. With government debt standing at over 200% of GDP, the government cannot easily accelerate fiscal spending, but disaster reconstruction work will provide a useful excuse.

8. Synthesis and conclusions

In the time since the Trump Administration announced in early October its intent to seek a phased trade agreement with China, including its intent to achieve a Phase I deal in the near term, financial conditions have been buoyed and indicators of business sentiment have been moving generally in a positive direction. To some extent these trends were already in train on a global scale, and they were given a further lift by shifting perceptions that the UK was more likely to avoid a disruptive no-deal Brexit. Indeed, our analysis of the relationship between global financial conditions and global PMIs suggests that business sentiment is in the process of troughing on a global scale and is likely to show modest further improvement in the next couple quarters. This is in line with our baseline expectation that global growth will be bottoming soon and will begin to pick up slowly as we move through 2020. With the yield curve steepening and other leading indicators improving, our recession probability models say the risk of a global recession anytime soon has been declining significantly.

Our analysis of developments at the national or regional level produces a more nuanced picture. In the US, although financial conditions have eased, business sentiment indicators remain depressed. Our models based on leading indicators tell us that US growth most likely is in the process of bottoming in the current quarter at a pace well below potential. Critical to this judgment is our assumption that trade tensions will dissipate further, including most importantly that the threat of the last tranche of China tariffs in December and the possibility of tariffs on autos from Europe are removed. Recession risks have declined noticeably assuming trade progress, and a moderate upturn in growth ahead still seems the most likely outcome, though election uncertainty should cap the upside (see " Little relief for capex as uncertainty pivots from trade policy to election ").

In Europe, too, the more cyclical manufacturing sector data have started to improve, helped by export orders, and our euro area data surprise indicator has turned positive for the first time in 20 months. The heightened uncertainty associated with trade policy and Brexit is poised to decline and start reducing the risk of the manufacturing shock spilling over into the domestic economy. Overall, we still feel relatively comfortable with our view that growth in the euro area will move sideways through the winter and pick up slowly beginning in Q2, about a quarter later than the upturn in US growth.

In Asia (ex Japan) the situation differs. Growth in the region has clearly been hit by the trade conflict, especially the smaller, more open economies, and most have yet to show clear signs of any turnaround, with the most recent manufacturing PMIs still in decline. China is an exception, where domestic demand growth may have bottomed and one of that country's PMIs has been moving sideways in recent months while the other has risen sharply. Overall, we expect enough recovery in China's trade and investment to offset a secular downtrend in that country's GDP growth over the quarters ahead and to foster a slow pickup in the rest of the region. In Japan, PMIs are still in decline, but external orders have begun to rise again. However, GDP is projected to remain depressed through Q1 by that country's consumption tax hike in October, and to begin to recover thereafter.

Our call that a global bottoming is near does rest importantly on the assumptions that a Phase I deal is signed in the relatively near term, auto tariffs are put aside for at least the year ahead, trade tensions ease somewhat further and hard Brexit risks subside. But the global economic picture remains fragile. Should a deal not be reached and the US/China trade war continue with tariffs raised as previously planned and a trade war with Europe over autos be opened, we would expect the global economy to continue to slide, very possibly into recession in the quarters ahead (see " If the crosscurrents strengthen, how far could global growth fall? ").

On the other hand, a surprisingly positive trade agreement, entailing a significant rollback of tariffs, could add up to several tenths to our baseline outlook for global growth over the year ahead. Very recent statements by the US Administration have reduced the probability of a surprisingly "trade dovish" outcome with a substantial rollback of existing tariffs. The recent stiffening of positions could be a negotiating tactic, and a rollback could still come. But we suspect that such progress would have to be induced by a painfully negative market and economic reaction to signs that the trade war was continuing or even escalating. On balance, we still see risks weighted a bit more heavily to the downside of our baseline global forecast.

Appendix 1

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